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The latest corporation tax statistics show that the finance and insurance sector was the largest single contributor to corporation tax in 2017/18, thanks in part to the bank surcharge, the loss restriction rules and increased profits, although receipts from the sector dropped 15% in 2018/19. In *Potter*, the FTT considers that the trading company test is satisfied for the purposes of entrepreneurs' relief despite gaps in trading and the lack of documentary evidence of the company's trading activities. The General Court publishes its judgments in the *Fiat* and *Starbucks* cases confirming that the Commission may use the arm's length principle to check that intra-group transactions endorsed by the relevant transfer pricing ruling correspond to prices that would have been negotiated under market conditions. HMRC publishes guidance in the Corporate Finance Manual.

Corporation tax statistics for banks/insurance companies

HMRC published the annual UK corporation tax statistics on 24 September which highlight that banks and insurance companies continue to be a key source of revenue. The finance and insurance sector was the largest single contributor to corporation tax with liabilities of £14.1 billion in 2017/18 (26% of corporation tax liabilities). This increase from £12.4 billion in 2016/17 was the highest of all sectors. Reasons for this include that banks' taxable profits have increased and their liability for corporation tax has increased through the bank surcharge of 8% and the loss restriction rules (which have applied to banks since 2016). Bank surcharge receipts have grown every year since they were introduced in 2016 and were £1.9 billion in 2018/19, a 5% increase from 2017-18. However, a 15% drop in receipts for 2018/19 may be an indication of incoming economic headwind.

Potter: trading test

Although *Mr and Mrs Potter v HMRC* [2019] UKFTT 0554 (TC) considered the trading company test for the purposes of entrepreneurs' relief, the decision of the First-tier Tribunal (FTT) is also relevant to the substantial shareholding exemption (SSE) which has the same definition of trading company. Mr and Mrs Potter's company, Gatebright, was involved in trading on, and advising others trading on, the London Metal Exchange (LME). Mr Potter was an 'introducing broker' and a 'dealer'. Gatebright brokered credit deals to provide finance to enable clients to engage in the high value trading at the LME. The credit deals were complex and could take months to negotiate.

At the time of the financial crisis in 2008/09, Gatebright had built up reserves of over £1m. In order to safeguard the reserves, around £800,000 was used to purchase two six year bonds maturing in November 2015, the remaining £200,000 was kept as working capital. Between March 2009 when the last invoice was issued and June 2015 when Gatebright entered liquidation, Mr Potter had, off and on due to ill health and other personal circumstances, tried to drum up more business. However, as a result of the financial crash, banks withdrew credit lines, there was little appetite for risk among clients and the volume of trades declined dramatically. There was no trade to be done because of the economic situation but Mr Potter continued to take steps to seek business and be ready to make new deals when the financial situation improved. As Mr Potter's attempts to gain business were made over the telephone or at lunches, Mr Potter was unable to produce any documentary evidence of the activities although

he maintained he was actively trying to continue the company's usual business trading up to June 2014.

The burden of proof was on Mr and Mrs Potter to show they were entitled to entrepreneurs' relief on the disposal on the liquidation of Gatebright. They had to show Gatebright was a trading company in the one year period leading up to 12 November 2012 (the date three years before the liquidation occurred). A trading company is one carrying on trading activities whose activities do not include to a substantial extent activities other than trading activities.

The FTT said the focus of the trading company test is on the activities of the company. The FTT concluded Gatebright was carrying out activities for the purpose of a trade it was preparing to carry on. The activities were carried out in the context of a trade which might be said to have paused as a result of the economic conditions. The whole purpose of the activities was to seek new business and prepare the ground for continuance of the trade once market conditions improved. Temporary gaps in activities do not prevent a company from trading 'throughout' the relevant period (otherwise companies would cease trading on Fridays and begin again on Mondays).

The FTT's approach was to look at a number of factors to consider whether the company was carrying on to a substantial extent activities that were not trading activities:

- There were no investment activities: purchasing the bonds was a single transaction entered into to protect the company's funds in the prevailing economic circumstances, and there was no further activity after the investment was made. The bonds could not be liquidated for six years. Neither expenses nor time were spent on non-trading activities.
- While assets and income pointed away from trading, the company's activities (including no investment activities) pointed to trading. Looking at the activities as a whole, they were directed at reviving the company's trade.
- If a substantial proportion of a company's expenses is spent on investment activities, it is not trading. The fact that a substantial proportion (if not all) of the company's income is derived from investment does not necessarily mean (as was the case here) that the company is not trading.

It is an encouraging decision for advisers looking to conclude that a company or group which looks and feels like a trading company or group but is on the wrong side of one or more of HMRC's '80% tests' nonetheless qualifies for SSE.

HCI guidance now published in Manuals

Guidance on the hybrid capital instrument (HCI) rules has been added to the *Corporate Finance Manual* (CFM) (paragraphs CFM35175 and CFM37610-CFM37690) and guidance on the stamp taxes implications of issuing/transferring HCIs will be added to the *Stamp Taxes on Shares Manual* in due course.

The CFM guidance helpfully includes a glossary of terms (CFM37820) and closely follows the legislation but also sets out HMRC's views on:

- the meaning of 'qualifying link' for the purposes of CTA 2009 section 352B: one of the conditions for eliminating tax mismatches is that there is a 'qualifying link' between an external loan relationship and one or more internal loan relationships. A qualifying link arises if the capital raised is wholly or mainly used to fund loan relationships between connected companies. HMRC accept that 'wholly or mainly' will depend on the circumstances. This can be evidenced through documentation such as a detailed policy on funding requirements (CFM35175);
- whether a provision has been included in an instrument because of a need to comply with

a regulatory requirement is not determined by focusing on a particular regulatory capital threshold at the time of issuance: in HMRC's view this is determined by whether the instrument reflects a commercial response by the issuer so that it can continue to meet its regulatory capital requirements (CFM37840);

- the main purpose test: in HMRC's view, two things would not normally alone indicate a tax purpose (CFM37840):
  - choosing a debt instrument, which includes a permitted coupon waiver, deferral features or write down/conversion features, for a commercial purpose (such as to qualify as regulatory capital or count towards their minimum requirement for own funds and eligible liabilities (MREL)); or
  - issuing hybrid debt to protect or enhance the company's credit rating in respect of more senior debt instruments;
- results dependent conditions in tax treaties: HMRC will adopt a similar approach to that adopted for deferral of interest and 'bail in' provisions in the context of the distribution rules in Part 23 CTA 2010 to ensure interest arising in the UK and paid to a beneficial owner resident in the other treaty state will be taxable only in that other State; and
- 'reasonably comparable terms': under CTA 2010 section 1015(3), interest payments can be treated as distributions if the instruments are convertible into shares and are 'neither listed on a recognised stock exchange nor issued on terms which are reasonably comparable with the terms of securities listed on a recognised stock exchange'. HMRC's view is that instruments not listed on a recognised stock exchange will be on reasonably comparable terms if they would have been entered into by independent parties and are of a type similar to those found on listed securities. HMRC expects genuine instruments that are issued commercially to meet this requirement (CFM37870).

Starbucks and Fiat: State aid transfer pricing cases

On 24 September, the General Court released its judgments on whether tax rulings on transfer pricing given to Fiat by Luxembourg (Cases T-755/15 and T-759/15) and to Starbucks by the Netherlands (Cases T-760/15 and T-636/16), respectively, constituted unlawful State aid. A key takeaway from both cases is that the arm's length principle is a general principle of EU law. Although Member States have a margin of appreciation to apply transfer pricing rules, the Commission can use State aid rules to police significant departures from the arm's length standard.

The State aid rules require the Commission to show that the transfer pricing terms agreed were not arm's length and that the tax ruling amounted to a selective advantage over other companies. Every case depends on its own facts. In *Starbucks*, the Commission failed to show a selective advantage (so Starbucks does not have to repay approximately EUR 30m) but in *Fiat*, it succeeded (so Fiat has to repay approximately EUR 21m).

Starbucks concerned coffee supply arrangements. The advance pricing agreement (APA) issued by the Dutch tax authority to a Dutch Starbucks company, SMBV, agreed a methodology for SMBV to determine its remuneration for its production and distribution activities within the group. The APA also endorsed the amount of royalty paid by SMBV to, Alki, another Starbucks entity which was established in the UK, for the use of the Starbuck's roasting IP. The royalty under the APA corresponded to SMBV's residual profit calculated by deducting SMBV's remuneration, calculated in accordance with the APA, from SMBV's operating profit.

The Commission found various errors in the agreed methodology but the General Court held that the

mere non-compliance with methodological requirements does not necessarily lead to a reduction of the tax burden. The Commission failed to demonstrate that the methodological errors identified in the APA led to a reduction of the tax burden as the General Court rejected the comparables set the Commission put forward. It is interesting that the Commission was not entitled to rely on matters subsequent to the conclusion of the APA (this is not the case under UK law which permits comparables and evidence from any period).

The tax ruling in *Fiat* concerned the transfer pricing methodology used for the intra-group financing activities of Fiat Finance and Trade Limited's (FFT). The method used consisted of an analysis on the return on capital but instead of taking into account the full amount of FFT's capital (which a third party lender would do when determining the amount and interest rate of a loan), the tax ruling permitted FFT to exclude 60% of its capital because it related to FFT's shareholding in two subsidiaries. This had the effect of limiting the capital base of FFT to be taken into account and increasing the arm's length cost of borrowing.

The General Court agreed with the Commission's decision that it is artificial to segment equity in this way. Capital is fungible and the whole of FFT's capital is exposed to risk and is available to support FFT's solvency so the whole of it must be considered in the calculation of FFT's remuneration. Luxembourg failed to establish that any other companies deducted an amount of capital attributable to their shareholding in subsidiaries, or that it is not common for financial institutions operating on the market to have such shareholdings. The methodology also permitted FFT to use a hypothetical regulatory capital amount of just EUR 28m rather than the total amount of equity of EUR 287m. None of the other companies in the transfer pricing report used as comparators used hypothetical regulatory capital as a profit level indicator.

The fact that lowering the tax paid by FFT in Luxembourg had led to a greater tax burden in another Member State had no bearing on whether there had been a selective advantage granted to FFT. If FFT's tax burden is lowered in Luxembourg, this is reflected in more advantageous pricing of the intra-group loans. As this was found to be ad hoc, individual aid, once the Commission had determined it granted an advantage, there was a presumption of selectivity.

The General Court rejected the arguments of Luxembourg and Ireland in Fiat that this novel application of the State aid rules to transfer pricing rulings would cause confusion and introduce uncertainty. This will be a significant point in the *Apple* case too.

Is it a good use of the Commission's time and resources to challenge individual tax rulings? In the UK, transfer pricing cases are rarely litigated as they are so fact dependent and evidence intensive. Transfer pricing of group financial transactions, in particular, is complex, as can be seen by the time spent by the OECD's working party on the final chapter on financial transactions for the Transfer Pricing Guidelines (TPG) which is expected to be published by the end of the year. The fact that the Commission is not, as the General Court in *Fiat* held, bound by the TPG is likely to cause some uncertainty in this area.

What to look out for:

- On 23 or 24 October, the Court of Appeal will hear the appeal in *Smith and Nephew Overseas Limited and others v HMRC* on whether loan relationship debits for foreign exchange losses arising on a change of functional currency are deductible.
- On 15 or 16 October, the Court of Appeal is scheduled to hear the taxpayer's appeal for judicial review in *Locke v HMRC* (follower notices and accelerated payment notices).
- The latest OECD proposals for taxation of the digital economy are to be presented to the G20 at their meeting on 17 October.
- The Taxation of Hybrid Capital Instruments (Amendment of Section 475C of the Corporation Tax Act 2009) Regulations come into force on 4 November (although they have effect from 1 January 2019).

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